PETER D. STERNLIGHT

NOTES FOR FOMC MEETING

FEBRUARY 1-2, 1982

Desk operations since the December meeting have been conducted against a background of strong monetary growth and higher interest rates. As the intermeeting period proceeded, the rise in money growth produced a steadily higher demand for reserves, compared with the Committee's path desired. The latest estimate placed the demand for reserves some $600 million above path, on average for the six-week interval. Largely in consequence, but also reflecting some downward adjustment of the nonborrowed reserve path to strengthen the resistance to excessive money growth, the banking system was pushed into substantially greater reliance on discount window borrowings. While borrowing trended higher over the period, there was considerable week-to-week variation--partly due to special pressures around the year-end period, and partly to short-run difficulties with reserve projections. For the whole period, including this week, borrowing may average about $1 1/4 billion.

At the start, borrowing was expected to be around $300 million, the near-frictional level indicated at the December meeting. This was expected to be associated with a Federal funds rate close to the 12 percent discount rate. Expected borrowing levels moved up to about $500 million around year-end and just afterward as money growth strengthened. Actual borrowing pushed even higher--to about $1 1/4 billion in the week that bridged the year-end. Further into January, as monetary strength persisted, expected borrowing levels grew to about $1.2 and then $1.5 billion. Actual levels fell short of, and then exceeded, these anticipated levels, with borrowings in the area of $750 million and then $2.3 billion in the weeks of January 20 and 27. The latter high level was partly induced by Desk action to make reserve needs more pressing early in the week, and then exacerbated by unexpected reserve shortfalls later in the week. So far in the current week, borrowing has averaged about $1.7 billion--somewhat above the anticipated $1.5 billion level.

The funds rate, meantime, climbed from levels modestly above the 12 percent discount rate at the beginning of the period. It temporarily averaged nearly 13 percent in the year-end week, briefly receded to around 12 1/2 and then rose more sturdily to about 13 and then 14 percent in the weeks of January 20 and 27. Thus far in the current week, funds have averaged about 14 1/2 percent--including a jump-up yesterday to about 15.70 percent which may have stemmed in good part from the publication of heavier borrowing last Friday. Today funds opened at 15 1/2 percent.

Day-to-day operations were complicated by the aforementioned pressures on bank reserve management around year-end and by considerable difficulties in projecting reserve supplies through much of January. The effects of bad weather, including a temporary shut-down of some Federal Reserve offices, contributed to these difficulties. Another factor was the exceptionally high Treasury balances at the Fed, as surprisingly heavy tax receipts came in after mid-January, and the Treasury was unable to put back funds in commercial banks to the desired extent.

For most of the period, the Desk was draining reserves, much of it offsetting the effects of reductions in currency. In fact, all of the System's outright operations were in a reserve-absorbing direction, roughly reversing the large outright acquisitions in late 1981. Holdings of Treasury bills were reduced by some $3.4 billion, including market sales of $1.4 billion, sales to foreign accounts of nearly equal size, and redemptions of $600 million. A small amount of agency issues was also redeemed. Repurchase agreements were used extensively around year-end, and again in the last several days to cope with the high Treasury balances. Matched sale transactions were employed continually with foreign accounts and on several occasions in the market as well.

Interest rates have pushed higher in the past six weeks, about as might be expected against the background of rising money supply, steeper day-to-day financing costs, and looming Treasury deficits. Much of the rate rise came early in the period, before the huge January money bulge was reported, as the market anticipated a bulge (albeit a lesser one). Also, the market was already reacting in December to the signs of money growth then apparent, and in early January to the absence of a post year-end easing in money rates that many participants had expected. Rising estimates of Treasury needs were also a factor. When the $10 billion money supply rise was reported in mid-January, it was something of an anti-climax and reaction was tempered by earlier anticipations and by expectations of a quick reversal of some of the bulge. Although the next week's numbers failed to provide that reversal, reaction was again moderated, in part by continued anticipation of declines to come and in part by the sense that reserve pressures were not mounting steeply. This past Friday, and continuing yesterday, there was a more substantial upward rate reaction as weekly numbers showed a disappointingly small decline in money and even more because of the sharp reported rise in discount window borrowing. Broadly speaking, though, the market reaction to money growth has been tempered by the sense that a slowdown or reversal in that growth is likely given the continuing evidence of weakness in the economy.

A subdued view of the economy has also moderated the reaction to new information on the Treasury financing outlook as it became clear that the Administration would not seek significant tax action to reduce forthcoming deficits. The market greeted rather calmly the Treasury's news of this week's $10 billion quarterly refunding operation, and their plans to borrow

$41 billion of net new cash in the current quarter. Both the mid-quarter refunding and the quarterly cash need are records.

Yields on intermediate and long-term Treasury coupon issues are up about 1/2 to 1 percentage point since the last meeting date, while the Treasury raised about $7 billion in the coupon area. A $5 billion 3-year note will be auctioned today and may yield close to 15 percent, compared with a yield just under 14 percent on that maturity just before the last meeting. A $2.5 billion 10-year note will be auctioned tomorrow and a like amount of reopened 30-year bonds on Thursday. Both may set auction yield records, although secondary market yields in those maturities were higher last fall.

Bill rates, meantime, have risen about 1 1/2 to 2 1/2 percentage points while the Treasury raised some $8 billion in the bill market. Both three- and six-month bills were sold yesterday at average rates of 13.85 percent, compared with 11.04 and 11.84 percent just before the last Committee meeting.

In other sectors of the capital market it is noteworthy that virtually no standard-type long-term corporate issues have been sold in the U. S. market in the recent period. Some corporations raised funds through zero-coupon offerings in the Eurodollar market, though, with Japanese investors reported to be particularly interested in such issues. The rise in corporate yields, like that in Governments, retraced part, but by no means all, of the sharp decline in yields in late 1981.

In the tax-exempt sector, though, yields hit new highs in the recent period, although there was some price recovery near the end as moderate investor demand and the light volume of new issuance produced some technical improvement.

NOTES FOR FOMC MEETING
February 2, 1982

Sam Y. Cross

Mr. Chairman:

Since the December meeting, and more particularly after the year-end, exchange markets have focussed very closely on the near-term prospects for monetary policy and interest rates--both in the United States and abroad. With unemployment rising throughout industrial Europe and North America, in some cases to levels considered politically unacceptable, market participants came widely to expect some moderation in the generally restrictive monetary policies that most countries had in place. At New Year's time, the questions being asked were: How much monetary easing would take place, and to what extent would these policy adjustments be coordinated among the major countries? Exchange market participants watched each and every development they thought might yield a clue about the course of interest rates in New York and other financial centers.

In early January, European interest rates indeed did generally drift downward, but U.S. money market rates moved higher, and this unexpected divergence pushed the dollar higher in the exchanges. This trend continued, and in the middle of the month there were widespread rumors that the G-5 had agreed to coordinate policy internationally and that the U.S. would either lower interest rates or join in exchange market intervention. But after a few days these rumors of concerted action vanished, as the differentials between U.S. and European interest rates continued to increase rather than to narrow. By the end of January, the market had come to the view that Europeans, in particular the Germans, might continue to ease their restrictive policies, even without easing on the part of the United States and despite possible exchange rate consequences. This view was strenghtened first when the Germans openly intervened in the amount of nearly in a three-day period, and later when improved current account data for Germany, released during the month, suggested more room for maneuver for the German authorities.

On balance, the dollar rose in January by about 4 1/2 to 5 percent against the continental currencies and by 5 1/2 percent against the yen. On three-month Euro-currencies, interest rate differentials expanded by more than 200 basis points against the continental currencies and by somewhat less against the yen. Yesterday and today the dollar has strengthened further, with the further increases in U.S. interest rates as well as the continuing political uncertainties in Germany. In the past 24 hours we have seen the dollar as high as 236.85 against the DM, and 233.75 against the yen, though it is now down a bit from those levels.

The exchange market's preoccupation with monetary policy adjustments may simply be a reflection of the views that volatile interest rates can induce capital flows that can swamp other influences on exchange rates. Or it may reflect the view that at times like the present when most countries' balance of payments changes are small and tending toward convergence and most countries' inflation rates are tending to decline, that such fundamentals will be of less importance than in the past in influencing exchange rate movements. Whatever the reason, the exchange markets' present concentration on interest rates is clear. And I should add, there is increasing criticism, in Europe and elsewhere, of what they see as a U.S. policy which results in great volatility of interest rates, which leads to great volatility of our and their exchange rates, while we are not prepared to help them deal with it in terms of intervention.